



OFFICE OF  
THE CHIEF ACCOUNTANT

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

February 9, 2001

Mr. Charles A. Bowsher  
Chairman  
Public Oversight Board  
One Station Place  
Stamford, Connecticut 06902

Dear Mr. Bowsher:

I would first like to compliment the Public Oversight Board (POB) for its increasingly diligent oversight of the SEC Practice Section's (SECPS) self-regulatory programs. I look forward to the adoption and implementation of the new POB charter, leading to a strengthened and unified system of governance for the accounting profession. I believe this will not only enhance the credibility of the accounting profession, but will also lead to further improvements in audit quality. I also look forward to the implementation of all of the other recommendations of the O'Malley Panel on Audit Effectiveness ("O'Malley Panel") and continued POB cooperation with the staff. In this regard, there are a few areas that I believe should be brought to your attention for further consideration.

Panel on Audit Effectiveness

In testimony before the O'Malley Panel, Chairman Levitt and I requested that the POB closely monitor the adoption and implementation of each of the O'Malley Panel's recommendations and report, at least annually, to the public on the progress being made on each recommendation.

I suggest that the POB establish a system for monitoring implementation of the O'Malley Panel recommendations that provides frequent public reporting of progress being made. I encourage that the report include the present status, timetables for completion, and a clear explanation of, and the reasons for, any deviation in the planned implementation of the O'Malley Panel recommendations.

SEC Practice Section Actions

It is commendable that the SECPS has responded quickly to the O'Malley Panel recommendations regarding improvements in the disciplinary process. We had positive discussions with members of the SECPS Executive Committee (EC) on a number of our concerns regarding the implementation of those recommendations, and we understand that those concerns were addressed at the EC meeting in January 2001.

Improving the Effectiveness of the Professional Ethics Executive Committee (PEEC)

SEC staff members have met in recent months with representatives of the AICPA's Professional Ethics Executive Committee (PEEC) regarding the status of disciplinary action following SEC enforcement actions against AICPA members. The SEC staff has been disappointed that in certain cases involving SEC actions against members of the AICPA, the AICPA failed to take any disciplinary actions.

One of the shortcomings of the AICPA disciplinary process is a lack of public accountability and reporting. For example, the public cannot readily determine whether the AICPA has taken a disciplinary action involving an AICPA member sanctioned by the SEC or another regulatory agency. In addition, there is no public reporting of PEEC actions taken with respect to cases rated by and referred to the PEEC by the QCIC and the SEC. And, unfortunately, many disciplinary actions are not made public. As a result of this lack of public accountability and reporting, the lack of visible disciplinary actions by the PEEC in the past, and decisions by the PEEC not to take action on some cases, the staff believes the process is ineffective.

To improve the PEEC process and its accountability, the staff requests that:

1. The POB adopt the recommendation in paragraph 6.23 of the O'Malley Panel Report and actively oversee the standard-setting process of the PEEC. As we have previously discussed, the SEC staff continues to believe that the POB should have oversight responsibility for the profession's disciplinary process, including but not limited to the PEEC.
2. The PEEC add to the "Annual Report of Ethics Division Activity," which now appears in the CPA Letter, the following:
  - a. A better description of the categories of disciplinary actions taken. In particular, the types of actions set forth in the letters of required corrective action should be adequately described so that the public can understand the types of corrective action specified. We note that cases resulting in actions such as letters of required corrective action, or additional continuing professional education, are not published in the monthly newsletter, and question if this provides adequate "sunlight" on the disciplinary process and its results.
  - b. The number of cases referred to the PEEC by the QCIC and the SEC, and the disposition of those cases, including when there is a determination made either not to investigate a case or not to take any disciplinary action after investigation.

- c. The numbers of cases deferred at the end of the year broken down by the length of time those cases have been deferred.
- d. The number of cases opened each year involving members of Big 5 firms, members of other firms, officers of companies, etc.

In addition, the staff recommends that the PEEC furnish the foregoing additional information to the POB and that the POB include such information in its annual report.

- 3. A majority of the PEEC members should be representatives of the public interest. Both Chairman Levitt and I have urged the AICPA and PEEC to adopt such membership requirements. In recent discussions with representatives of the AICPA and the Big 5 accounting firms, it was agreed that the firms, the AICPA leadership, and the SEC staff would support an approach that would result in membership of the PEEC being comprised of an equal number of public and professional members. The AICPA is to be commended for adding three public representatives to the PEEC, but they are a very significant minority on this large committee. (See attached statements of the AICPA, Deloitte & Touche, and Arthur Andersen).

I have heard a concern expressed by some in the profession regarding a perception that members of AICPA committees and partners in large accounting firms are treated more leniently in the disciplinary process than accountants outside those categories. I am not in a position to express whether this concern is reality. However, I encourage the PEEC to undertake to review its procedures to assure equivalency of treatment among accountants from firms of all sizes.

Finally, the O'Malley Panel Report describes the QCIC process and the ratings assigned to its cases. QCIC in turn refers cases to the PEEC. Ultimately, those cases may end up with the Joint Trial Board, whose decisions are not under the jurisdiction of the PEEC. I recommend that the POB closely monitor the adequacy and fairness of the ratings by the QCIC, and evaluate whether cases referred to the PEEC which come before the Joint Trial Board are dealt with in an appropriate fashion.

#### Letters of Comment

The SECPS is currently undertaking a reconsideration of the format of the standard peer review report and the letter of comment and I encourage the POB's close oversight of this project. My staff's experience with a particularly uninformative letter of comment during our February 2000 oversight visit to the POB increases my concern in this area. The letter of comment must contain a clear, concise, transparent and informative discussion of significant issues noted during the peer review. Investors and other regulators, such as the banking regulators, should be able to read the public letters

of comment and have a transparent view of the nature and significance of deficiencies deemed serious enough to be reported.

The troubling Business Week article (see copy attached) only re-enforces my concerns, especially with respect to the potential lack of objectivity and candid feedback between the large firms. I fear that similar issues may be present in varying degrees in the current peer review process. In addition, consolidation of the Big Eight firms into the Big Five has heightened concerns about the objectivity of a "firm on firm" peer review process. It is important that the POB's oversight of the peer review process be diligent and comprehensive in order to provide public assurance about the objectivity and fairness of the process. I fear that any further consolidation among the major accounting firms will require a significant change to the manner in which effective quality control assurance will be performed. For all of these reasons, it will take continued strong and effective oversight by a truly independent and vigilant POB to assure the objectivity and integrity of future peer reviews.

#### Improving the Quality of Audits

As financial frauds continue to surface, and given the O'Malley Panel's observations about audit quality, I urge the POB to continue to monitor "audit re-engineering", and help assure that the audit not be allowed to slip away from substantive testing of facts and figures to mere "audit by conversation." In 1997, the Chief Accountant sent a letter to the POB expressing concern about the effects of "audit re-engineering" on audit quality, including reduced audit hours and substantially reduced audit documentation in certain areas (copy attached). The POB responded to this by increasing its monitoring of this development and through the establishment of the O'Malley Panel.

The O'Malley Panel made a number of recommendations for improvement in audit documentation (see paragraphs 2.74, 2.94, 2.102, 2.116, 2.157, 2.185, 2.229 of its August 31, 2000 report). In paragraph 2.229 the O'Malley Panel observes "(t) he QPR (quasi peer review) disclosed that working paper documentation often was less than adequate from the reviewers' perspective." In paragraph 3.29, the O'Malley Panel states "...even in the face of the strengthened auditing standards issued over the past 15 or so years, audit firms may have reduced the scope of audits and level of testing, at least in part as a result of redesigning their audit methodologies."

The Auditing Standards Board should promptly address the shortcomings in audit documentation noted by the O'Malley Panel. The ASB is currently revising its standard on working paper documentation. However, the ASB seems to be moving away from a "reperformance" based standard. The SEC staff feels strongly that it is critical that the working paper documentation must permit a reasonably prudent auditor to reperform the actual tests performed by the engagement personnel, based on the information

documented in the working papers. This includes the ability to identify the specific items tested. This level of documentation is absolutely necessary for:

- Adequate supervision and review of the work performed,
- The ability for competent internal quality control assurance, and
- Internal and external peer reviews.

I also believe that a documentation standard based on the concept of "reperformance" as outlined above will result in a higher level of performance by the engagement team.

Also, I note that the ASB is responding to recommendations of the O'Malley Panel Report for more specificity in the auditing standards. I wholeheartedly agree with these recommendations and look forward to the ASB upgrading its standards. The standards that exist today contain far too little guidance and are overly broad, especially given that the majority of the actual audit hours performed are by less experienced staff. Issues we have encountered in enforcement cases involving a lack of adequate testing of loss accruals, confirmations not properly used, inadequate testing of non-standard journal entries, inappropriate assessment of the materiality of passed audit adjustments, reliance on internal controls that were overridden by management, and inappropriate use of analytical procedures are all examples of situations where more detailed and specific standards could have had an impact, and would have provided greater investor protection.

#### Audit Committees

The role of the audit committee in the protection of investors has been the focus of significant activity in the past several years. The Kirk Panel Report and the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, followed by the new rules of the stock exchanges, the Auditing Standards Board and the SEC have all contributed to more effective audit committees.

In order to maintain the positive momentum, I encourage the POB to monitor developments as audit committees and auditors exercise their respective responsibilities. For example, the POB could encourage the further development and implementation of "best practices" in the future, perhaps in cooperation with the stock exchanges. I also encourage the POB to monitor auditors' compliance with the reporting requirements of ISB Standard No.1 and Statement on Auditing Standards No. 90.

### Improving Peer Review and Quality Controls Related to Independence

The POB has an important role to fulfill in the oversight, review and reporting on the quality control systems that firms are required to implement as part of the voluntary "Look Back" program. These systems should have been designed and implemented by December 31, 2000, with testing of the operational effectiveness of the systems to commence at the end of June 2001.

Registrants and the Commission continue to be faced with situations where the quality controls that have existed at a firm were insufficient to ensure compliance with the most basic independence rules. Some situations have raised questions as to why previous peer reviews performed under the oversight of the POB did not detect these deficiencies at an earlier date. It appears that perhaps one possible reason is that controls are being considered in light of previous practices and not in light of changing developments within the firms that may warrant changes in quality control systems.

Accordingly, the staff would like to meet with representatives of the POB, its staff and the necessary experts or consultants the POB will hire, to gain a better understanding of the work program the POB intends to undertake to fulfill its obligations in connection with the "Look Back" program.

### Management Advisory Services

The staff is concerned that the term "auditing and accounting services," as contained in the SECPS membership requirements at ¶1000.08g(12) and (13) is not being interpreted on a consistent basis by all firms, and thus the data that is reported in firms' AICPA annual reports may not be comparable from firm to firm. The staff believes that term should only include annual audit and quarterly review fees, and not internal audit, risk management and other fees.

I reiterate my request that the statistical information concerning Management Advisory Services, which was previously published in the now-discontinued SECPS annual report, be published in the POB's annual report or in some other way that makes it readily available to, and accessible by, the public.

### Continuous Peer Review - Recommendations of the O'Malley Panel

The SEC staff would be pleased to work with the SECPS and the POB staff to determine the best means possible for us to participate in a timely and meaningful continuous peer review process, including continuing our access to the work product.

### Report of the POB

In March 1993 the POB issued a landmark special report entitled In the Public Interest, which was a report on issues confronting the accounting profession and recommendations as to how those issues could best be addressed by various parties, including Congress, the SEC, the standard setting bodies, audit committees, the AICPA and the accounting firms. Within the context of continuous improvement, I encourage the POB to consider updating that report for subsequent developments and changes that have occurred.

### Independent Oversight on Behalf of Investors

The POB was created to serve as an independent board that would represent the interests of the public through its oversight of the accounting profession and the profession's self-governance structure that was created at the same time. Maintaining the POB's credibility with the investing public is important to the accounting profession and the U.S. Capital markets. In that regard, a number of presenters at the recent public hearings of the Commission raised a number of issues important to investors and the capital markets, including the following significant issues:

- The ability of the profession to attract and retain new college graduates. We noted that enrollment in the various departments of the colleges of business, including accounting, along with other programs such as engineering, computer science and mathematics, has declined. We also noted that the salary differential between accounting graduates and graduates with other competing degrees has grown significantly in the past ten years.
- Impact of technology on performance of audits and audit quality.
- The need for expanding the types of financial information provided by public companies to investors, and the auditor's involvement with these disclosures.
- "Lowballing" of audit fees to obtain a client relationship and non-audit services.
- Importance of the audit function within the accounting firms
- Consolidation among both large and small accounting firms, including consolidation with "consolidators" involving non-CPA ownership or management of the audit function.
- Leadership within the accounting profession.
- Impact of the divestiture by accounting firms of their consulting practices and the positive or negative effect, if any, on the performance and quality of audits.

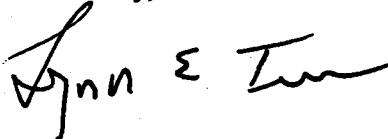
- Ongoing compliance of U.S. firms and their international affiliates with the SEC's and the profession's independence rules and quality controls.

Several of these same issues were also raised in the O'Malley Panel Report.

The POB has an important responsibility to the public investor - one that flows naturally from the proposed charter which, if adopted, would establish a unified and strengthened system of governance for the profession. In this regard, I believe that it is essential for the POB and the SEC to meet periodically to discuss significant issues relating to the accounting profession.

I appreciate your continued commitment to the public interest. I would be pleased to have a meeting with the Board to discuss this letter at your convenience. Please contact either Mike Kigin at (202) 942-4421 or John Morrissey at (202) 942-4400 to set up such a meeting.

Sincerely,

A handwritten signature in dark ink, appearing to read "Lynn E. Turner". The signature is fluid and cursive, with the first name "Lynn" being the most prominent part.

Lynn E. Turner  
Chief Accountant

**Attachments**

cc (w/o attachments):

Michael A. Conway, Chair, SEC Practice Section  
James S. Gerson, Chair, Auditing Standards Board  
James L. Curry, Chair, Professional Ethics Executive Committee  
Susan S. Coffey, Vice President Self Regulation and SECPS, AICPA



## I. Concerns with the POB

- POB funding was cutoff when the SEC staff requested special reviews to be performed
- The POB has raised concerns but have not addressed them (e.g. independence)
- The POB allowed the AICPA's SEC Practice Section to drop its report
- The Panel on Audit Effectiveness noted in its report that there has been a reduction in the scope of audits and there has been a lack of audit documentation
- The Panel on Audit Effectiveness also noted that the POB's oversight has not extended to appropriate organizations (e.g. Auditing Standards Board, Independence Standards Board, PEEC)

## II. Panel on Audit Effectiveness August 31, 2000 Report

- SEC staff has requested POB to monitor implementation of recommendations by constituents
  - Report has been out for 4 months and POB has not yet provided the SEC staff with any indication on how it will respond to recommendations
  - Recommendations
    - POB should request constituents to provide it with an action plan and timetable
- POB Charter
  - Panel recommended a formal charter that would significantly strengthen the Public Oversight Board (POB)
    - Charter proposed by the POB is weaker than the Panel recommended.
      - Approval of committee chairs and members
      - Nominating committee
      - Oversight of disciplinary body
  - Recommendations
    - Charter should be adopted and implemented immediately
    - POB needs "no strings" funding and the authority to conduct appropriate special reviews of firms' practices to fully discharge its public responsibilities.
    - Adopt all of Panel's recommendations
- Disciplinary
  - Current PEEC is ineffective
    - Disciplinary meeting occur behind closed doors
    - Slow process
    - All members are with the profession

- PEEC has not taken action where the SEC has taken action and some actions taken have been insufficient
  - Only 3 of 21 members are public members
  - Entity is not overseen by the POB
  - Many disciplinary actions are not published
- Recommendations
  - Increase public membership
  - Conduct meetings in the “sunshine”
  - Consider steps to accelerate process including legislation
- Peer Reviews
  - Current peer review process could be improved
    - Limited information to the public on peer review results
    - Information provided to public is diluted
    - Process only occurs every 3 years
    - Public letter setting forth findings lack transparency and clarity
    - Appears to be too much “back slapping”
  - Recommendations
    - Peer review process needs to be continuous
    - Results need to be “in the sunshine” and transparent